Small business investments

State laws have been relaxed to make it easier for small business to raise start-up and growth financing from the public. Many investors view this as an opportunity to "get in on the ground floor" of an emerging business and to "hit it big" as the small businesses grow into large ones.

Statistically, most small businesses fail within the first few years. Small business investments are among the most risky that investors can make. This guide suggests factors to consider for determining whether you should make a small business investment.

Risks and investment strategy

A basic principle of investing in a small business is: *Never make small business investments that you cannot afford to lose!* Never use funds that may be needed for other purposes, such as college education, retirement, loan repayment, or medical expenses. Instead, use funds that would otherwise be used for a consumer purchase, such as a vacation or a down payment on a boat or a new car.

Above all, never let a commissioned securities salesperson or office or directors of a company convince you that the investment is not risky. Small business investments are generally hard to convert to cash (illiquid), even though the securities may technically be freely transferable. Thus, you will usually be unable to sell your securities if the company takes a turn for the worse.

In addition, just because the state has registered the offering does not mean that the particular investment will be successful. The state does not evaluate or endorse any investments. If anyone suggests otherwise, they are breaking the law.

If you plan to invest a large amount of money in a small business, you should consider investing smaller amounts in several small businesses. A few highly successful investments can offset the unsuccessful ones. However, even when using this strategy, *only invest money you can afford to lose.*

Analyzing the investment

Although there is no magic formula for making successful investment decisions, certain factors are considered important by professional venture investors. Some questions to consider are:

1. How long has the company been in business? If it is a start-up or has only a brief operating history, are you being asked to pay more than the shares are worth?

2. Consider whether management is dealing unfairly with investors by taking salaries or other benefits that are too large in view of the company's stage of development, or by retaining an inordinate amount of equity stock of the company compared with the amount investors will receive. For example, is the public putting up 80 percent of the money but only receiving 10 percent of the company shares?

3. How much experience does management have in the industry and in a small business? How successful were the managers in previous businesses?

4. Do you know enough about the industry to be able to evaluate the company and to make a wise investment?

5. Does the company have a realistic marketing plan and do they have the resources to market the product or service successfully?

6. How or when will you get a return on your investment?

Making money on your investment

The two classic methods of making money on an investment in a small business are resale of stock in the public securities markets following a public offering, and receiving cash or marketable securities in a merger or other acquisition of the company.

If the company is not likely to go public or be sold out within a reasonable time (i.e., a family-owned or closely held corporation), it may not be a good investment for you – despite its prospects for success – because of the lack of opportunity to cash in on the investment. Management of a successful private company may receive a good return indefinitely through salaries and bonuses, but it is unlikely that there will be profits sufficient to pay dividends in proportion with the risk of the investment.

Other suggestions

Investors must be provided with a disclosure document – a prospectus – before making a final decision to invest. You need to read this material before investing.

Even the best small business venture offerings are highly risky. If you have a nagging sense of doubt, there is probably a good reason for it. Good investments are based on sound business criteria and not emotions. If you are not entirely comfortable, the best approach is usually not to invest. There will be many other opportunities. Do not let a securities salesperson pressure you into making a decision.

It is generally a good idea to see management of the company face-to-face to size them up. Focus on experience and record of accomplishment rather than a smooth sales presentation. If possible, take a sophisticated businessperson with you to help in your analysis.

Beware of any information that differs from, or is not included in the disclosure document. All significant information is required by law to be in the disclosure document. Immediately report any problems to the Hawaii Office of the Commissioner of Securities.

Conclusion

Greater number of public investors are “getting on the ground floor” by investing in small businesses. When successful, these enterprises enhance the economy and provide jobs. They can also provide new investment opportunities, but the advantages must be balanced against the risky nature of small business investments.
In considering a small business investment, you should proceed with caution, and above all, *never invest more than you can afford to lose!*

For more information

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